

Interest Free Banking and Economic Stability

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Abstract

This study examined the growth and development of interest free banking in Pakistan. This study also analyzed how economic stability can be achieved in the system of interest free banking. This study showed how state bank of Pakistan is playing role for the development of interest free banking. The secondary source of data of GDP per capita, investment, consumption and inflation covering the time series period 1973 to 2014 is employed. OLS technique and Unit-Root-Test has been used. The main idea of this paper is that how economic stability can be achieved in interest free banking. The Holy Quran clear that interest earning is unlawful it has been also cleared by many economist that due to interest rate economic disability can caused. Interest free banking was introduced in Pakistan in 1980 for the first time. This study showed that interest is forbidden by Sharia and Islam promotes investment and consumption. This paper helps to policy maker how development of Islamic banking can be achieved in Pakistan.

Keywords: Interest free banking, GDP, Consumption, Investment, Economic development, Inflation, Riba free Banking

Introduction:

Interest is surplus of wealth. Holy Quran uses the word Riba to represent interest. Interest means raise, adding up, increase and growth. Yet, Holy Quran has confirmed not all increase in wealth is unlawful for the reason that increase to assets takes in trade as well. Holy Quran forbids only a particular type of increase in wealth. So for that reason it is call Riba. Holy Quran also made it clear that any increase to capital gained in trade is lawful while any excess in form of interest is unlawful.

Interest is cause of establishment the economy. An U.S Economist “Milton Friedman” studied economic ups and downs and relate to the reduce in interest- rate. A high rate of interest can create hesitation in the investment (capital) market. While the economy base on Shirakah (partnership) in loss and homecoming would be greater stable this reason of economic stability has been acknowledged by U.S economist as well as “Bayman Simon” (1948) and “John Walson” (1977).

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Interest free banking is not a quite new thought. Interest free banking is a notion base on law of Sharia. Interest free banking was introduced in the early 7th century at some stage in what is known as Islamic “Golden Age”. Interest is like a backbone of capitalistic economy. But in Islamic economy there is no concept of interest rate because interest is strictly forbidden by sharia. Interest is forbidden in Islam while Islamic laws and principles encouraged investment, profits and trade.

يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنْتُمْ مُؤْمِنِينَ لَكُمْ تَفْعَلُوا فَادُّنُوا بِحُزْبٍ مِنَ اللَّهِ وَرَسُولِهِ وَإِنْ تُبْتِغُوا فَلَئِنْ كُنْتُمْ تُظِلُّونَ وَلَا تُظَلَّمُونَ¹

“O ye who believe! Fear Allah and give up what remains of interest, if you are truly believers. But if you do it not, then beware of war from Allah and His Messenger; and if you repent, then you shall have your principal; thus you shall not wrong nor shall you be wronged”.⁽²⁾

Instead of issuing interest-bearing loans, the interest free banks have to enter into Shirakah or Mudarba transactions. The profit and loss should be shown in the overall balance sheet of the banks. There should be no contract based upon fix amount of addition to capital. Our great leader Quaid-e-Azam showed his interest to develop the Islamic banking. Before 1970 there was no concept of “Islamic banking” but later on the concept of “Islamic banking” was introduced in 1980 on that time when state bank of Pakistan changed hi rules.

Economic stability cannot be achieved in interest bands economy. The Holy Quran has given proper guides about lawful business. The excess amount of capital which not fixes but based on loss and profit is lawful. Islam provides the rate of interest while Islam promotes the investment. It has been studied by great economists that investment has positive impact of economic growth. Economic stability can be achieved when investment ratio will be increased. While interest rate has negative impact on economic stability due to interest rate economic will be unstable.

In the interest free banking GDP is positively related to the investment but negatively related to the interest rate GDP of an economy will increase when ratio of investment will increase. GDP will decrease when interest rate will increase. Investment has positive impact in Riba free economy.

Trend:

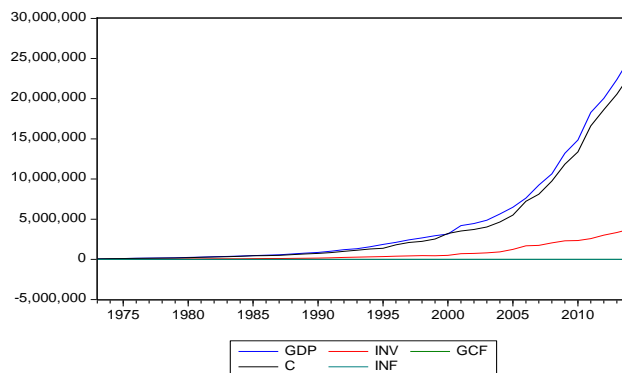
GDP= gross domestic product

INV= investment

INF= inflation

CON= consumption

GCF= gross capital formation



In the above graph we have trend lines of GDP, INV, CON and GCF. The green trend line is describing the GCF as can be seen that from the year 1973 to 2014 is constant there is no variation. The red trend line is describing the investment trend line. Investment seems to be constant from year 1973 to 1992 while after that year there were variations it will go on increasing as can be seen from the year 2000 to 2014 investment increases at the end of the 2014 it was about 400,500. The black trend line is the line of consumption in the year 1983 the variations were observed in consumption trend line. While after 1995 there was rapid increase in consumption. At the end of 2014 it was about 23,000,000. The blue trend line is the GDP trend line as we can see it was constant from 1973 to 1983. After that it will go on increasing and at 2005 it was 5,000,000, at 2010 it was about 12,000,000. It will rapidly increase due to increase in consumption and investment.

Literature review:

Lodhi and Kalim² analyzed that Strategic Direction for Developing an Islamic Banking System in 2005. This study used time series data. This study adopted graphical method. The duration of this study was (1992 to 2001). This article took the variables total deposits, interest rate, growth of economy and capital. The end result of this reading showed that there are some of the key factors that are major obstacle for the development of Islamic banking system. To improve Islamic banking system we need to maintain these factors.

Kleem and Isa³ examined that Islamic Banking and Money Demand Function in Malaysia. This study used time series data. This study adopted regression analysis method. The variables which used in this article were GDP, inflation, interest rate, money demand; R stands for (CPI) and nominal interest rate. The study of dual Islamic banking in Malaysia showed the final result that present Islamic banking system is not suitable of growth of Islamic banking. Furquni and Mulyany⁴ analyzed the "Islamic Banking and Economic Growth: Empirical evidence from Malaysia". This study used time series data and applied Vector-Error-Model (VECM) and co integration test. This study took the variables Islamic banking financing (IB Financing), real GDP per capita (RGDP), trade and fix investment. The final result explained that there is direct connection between Islamic bank financing and economic development in long run.

Komijani and Akbar⁵ investigated that “Performance of Monetary Policy under Interest Free Banking Law in Iran”. This study used the time series data and percentage method. The period of this study was (1999 to 2000). This study took the variables economic growth, inflation, liquidity, capital formation. This study showed the result that in period (1972 to 2010) Central Bank of Islamic Republic of Iran had not acceptable performance of achieving the aims of monetary policy. Antolin et al⁶ investigated that The economic impact of Protected low Interest Rate on Pension Funds and Insurance companies. This study used panel data. The study adopted graphical method. The duration of this study was from (2001 to 2010). This study took the variables low interest rates, funds, pensions, life insurance, non-life insurance and finance. The final result showed that low interest rate had great impact on funds, life time insurance companies and also have great impact on investment.

Aif et al⁷ investigated that Riba Free Economic Model. This study used time series data. In this article Two stage least square (2SLS) technique had been used. This study took the variables GDP, interest rate, saving, investment, consumption and growth rate. The final result of this article showed that the Riba free economy had direct effect on the growth rate there exists positive relationship development in short run and long run period. Farhani et al.⁸ investigated that “Analysis of IslamicBank’s Financing and Economic Growth: Case study Iran and Indonesia”. This study applied unit-Root test. The study used panel data and period (2000 to 2004). They used the variables GDP, Gross fixed capital formation (GFCF), total Islamic banking finance (FIN), (INT), investment. The study showed the result there is direct correlation between economics growth and financial development in (RS) short run and (LR) long run period.

. Muhammad and Shawan⁹ analyzed that “The Objective of Islamic Economics and Islamic Banking In light of Maqasid Al-Shariah”. This study used time series data in 2013. The study adopted content analysis and inductive method. This study took the variables economic growth, financial assets, interest rate, and GDP. This study showed the result that the main objectives of the authors were to highlight the status between disciplines of Islamic banking and Marquis of Islamic banking. Islamic banking need attention to these two objectives for the economic development.

Sarwer et al¹⁰ examined that Does Islamic Banking System Contributes to Economy Development. This study used time series data and interviewing method. The variables which had been used in this study were interest rate, economic growth, GDP, financial sector development. The study showed the result that Islamic banking system had positive effect on economics growth it also decrease inflation and also less risky for investors. Muhammad Ashraf¹¹ examined that Development and Growth of Islamic Banking in Pakistan: This study used time series statistics and the phase from (2008 to 2012). This study used percentage method. This study took the variables total assets, deposits, net finance, investment, and interest rate. The result of this study showed that to improve the growth of Islamic banking system there should increase the interest free financial services.

Data and Methodology:**Nature and Source of Data:**

This study time series data of 42 years has been choose. The data which is used in this paper is secondary data and from the period 1973 to 2014 and it is data which has been chosen on annually. The OLS econometric technique is applied.

Table 1: Description of Variables

<i>Variables</i>	<i>Descriptive Variables</i>	<i>Unit of Measurement</i>	<i>Source</i>	<i>Sign</i>
<i>Dependent Variable</i>				
<i>GDP</i>	<i>Gross Domestic Product</i>	<i>Million Rupees</i>	<i>SBP</i>	<i>+ve</i>
<i>Independent Variable</i>				
<i>INV</i>	<i>Investment</i>	<i>Million Rupees</i>	<i>SBP</i>	<i>+ve</i>
<i>CON</i>	<i>Consumption</i>	<i>Million Rupees</i>	<i>SBP</i>	<i>+ve</i>
<i>INF</i>	<i>Inflation</i>	<i>Million Rupees</i>	<i>SBP</i>	<i>-ve</i>
<i>GCF</i>	<i>Gross Capital Formation</i>	<i>Percentage</i>	<i>WDI</i>	<i>-ve</i>

(Note: Data has been collected from WDI and SBP)

Methodology:

In statistic linear least square or ordinary least square (OLS) is a econometric technique which is used to estimate unknown parameters. The OLS technique is developed by “Carl Fried Gauss” in 1821.

$$Y = \beta_1 + \beta_2 X_2 + \beta_3 X_3 + \dots + \beta_n X_n + \mu$$

Where

Y= Regressed variable

X_i=set of explanatory variables and

μ=disturbance term

Specification of Model:

$$Y = f(\text{GDP}) \text{ ----- (1)}$$

Y= output

GDP= Gross domestic Product

Equation 2:-

$$\text{GDP} = \beta_0 + \beta_1(\text{INV}) + \beta_2(\text{INF}) + \beta_3(\text{CON}) + \beta_4(\text{GCF}) + \varepsilon$$

Where sign represent

GDP= gross domestic product

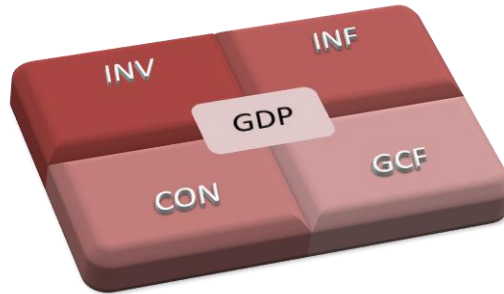
INV= investment

INF= inflation

CON= consumption

GCF= gross capital formation

There are some of variables that effect (GDP) such as investment, inflation, consumption.



Description of the Variables:

GDP:

In this model GDP is gross domestic product it refers the economic growth. GDP include the expenditures of consumption, investment, government spending and earnings from exports if our investment ratio is increasing then its mean our GDP is positive. In interest free banking GDP is negatively related to interest rate. Economic stability can be achieved only by increasing investment.

INV:

Islam for Hibbing the interest rate the Holy Quran cleared that earnings on the basis of loss and profit is lawful. It is studied by economists that investment is the way to achieve economic stability. Investment is positively related to the GDP. If we want to increase economic growth the investment should be increase while interest rate can decline the investment and also cause economic disability.

CON:

Consumption has positive relation with GDP. In Riba free economy there is direct relation between GDP and consumption. In this model consumption refers to Zakat. Zakat enhance the aggregate demand and shifts the consumption function upward. Current consumption of household increases at the same level of income. In Riba free economy there is positive impact of consumption on economic development.

INF:

Inflation is the increase in general price level. When money supply increases it will cause the rise in general price level that is called inflation. There is strong relation between interest rate and inflation. When interest rate will come down

then consumption level will be increase due to this the prices will increase and cause inflation.

GCF:

Gross capital formation (GCF) consists of addition to the outlays and fix assets of the economy. It is the component of expenditure approach it also refers to the increase in capital stock. It is also main determinant of measuring economic growth. There is negative relation between GCF and INF.

Table 2: OLS Model:

<i>Variables</i>	<i>Coefficient</i>	<i>t.Statistic</i>	<i>Probability</i>
GDP	0.487634	4.904161	0.0000
INF	-0.009807	-1.318434	0.1955
INV	0.266617	4.278385	0.0001
CON	0.740653	12.32722	0.0000
GCF	-0.015392	-1.847712	0.0727

(NOTE: Calculation based on software 7.0 E. views)

In above table we have dependent variable GDP and independent variable as we have

INF, CON, GCF, INV. We have significant dependent variable GDP and INV; CON is also significant while INF is insignificant. INV and CON is positive relationship to the GDP.

Coefficient of GDP is equal to 0.487634 and INF value of coefficient is negative that is -0.009807. 0.266617 is coefficient value of INV .While 0.740653 is coefficient value of CON that is consumption. My result explains that value of INV is significant to GDP that means there is positive relation.

Table 3: Descriptive Statistics

<i>R-squared</i>	0.999362	<i>Mean dependent Var</i>	14.18637
<i>Adjusted R-Square</i>	0.999293	<i>S.D. dependent var</i>	1.700892
<i>Probability</i>	0.000000	<i>Hannan-Quinn</i>	3.166630
<i>F.Statistic</i>	14481.34	<i>Durbin-Watson</i>	1.528466

In the above table the value of R-square is 0.999362 and adjusted r- square is 0.9999293 we can see by this result that 99% of GDP is affected by violation in inflation , investment , and consumption . The value of Durbin-Waston is 1.528466 which is greater than R-square .In the above table probability is equal to 0.00000 and value of f-statistic is 14481.34.

Table 4: Descriptive Statistics:

VA R	Mean	Median	Maximum	Minimum	Skew n	Kurto sis	J.B	Pro
GD P	14.18 637	14.18 186	17.037 11	11.131 27	- 0.001 55	1.888 669	2.161 366	0.3339 364
IN F	1.528 325	1.909 287	3.0099 31	3.6119 18	- 2.397 583	9.678 352	118.2 895	0.0000 000
CO N	14.05 819	14.01 058	14.010 58	10.974 75	0.032 899	1.921 024	2.044 90	0.3597 11
IN V	12.46 625	12.58 10	15.138 89	9.1599 94	- 0.104 15	1.971 242	1.928 03	0.3813 57
GC F	1.444 71	1.525 63	2.9194 91	- 1.3899 8	- 1.039 37	4.608 77	12.09 130	0.0023 68

(NOTE: Calculation based on software 7.0 E. views)

In this table the mean of GDP is 14.18637, maximum on point 17.03711, minimum on point 11.13127 and positive skewness. It is pletykurtic and normally distribution. The mean value of INF is 1.528325, maximum at point 3.009931, minimum at point, -3.611918 and positive skewness. It is leptokurtic and normally distributed. The mean value of consumption is 14.05819, maximum at point 14.01058, minimum at point 10.97475 and positive distributed. It is also pletykurtic and normally distributed. 12.46625 is the mean value of INV it is maximum at point 15.13889 and minimum at point 9.159994. It is positive skewness and pletykurtic. The mean value of GCF is 1.44471 it is maximum at point 2.919491, minimum at point -1.38998. It is positive skewness and leptokurtic. GCF is normally distributed.

Table 5: Correlation Matrix

<i>Variables</i>	<i>GDP</i>	<i>INF</i>	<i>INV</i>	<i>CON</i>	<i>GCF</i>
<i>GDP</i>	1				
<i>INF</i>	0.538167	1			
<i>INV</i>	0.997910	0.560960	1		
<i>CON</i>	0.999507	0.537025	0.997191	1	
<i>GCF</i>	-0.227696	-0.094840	-0.212437	-0.222566	1

(NOTE: Calculation based on software 7.0 E. views)

The correlation between INF and GDP is positive and it is also positive between INV and GDP. The correlation between CON and GDP is positive while it is negative between GCF and GDP. The correlation between INF and INV is positive and it is also positive between CON and INF. But the correlation is negative between GCF and INF. The correlation between INV and GCF is negative. The correlation between CON and GCF is negative.

Table 6: Unit Root Test

<i>Variables</i>	<i>DF-GLS</i>	<i>TEST Ist</i>	<i>PP Level</i>	<i>TEST Ist Diff</i>	<i>ADF Level</i>	<i>TEST Ist Diff</i>	<i>RESULTS</i>
<i>GDP</i>							I(1)
<i>Intercept</i>	0.3898	1.1031	1.3213	7.0970	1.2853	6.9921	
<i>T&I</i>	2.5297	5.6254	4.1756	6.9362	4.1785	6.9362	
<i>None</i>			14.168	51.749	16.306	1.1692	
<i>INF</i>							I(0)
<i>Intercept</i>	1.6216	1.3144	4.3992	13.570	4.4185	12.079	
<i>T&I</i>	5.4470	3.0138	5.4550	14.999	5.3865	12.700	
<i>None</i>			2.0568	13.151	0.2282	11.822	
<i>INV</i>							I(1)
<i>Intercept</i>	0.8701	3.8068	2.2906	4.8338	2.2906	4.9327	
<i>T&I</i>	2.2890	4.9033	4.7856	4.9623	4.8116	5.0627	

<i>None</i>			7.2618	2.3234	8.8086	2.0384
<i>CON</i>						I(1)
<i>Intercept</i>	0.4450	0.6289	0.9858	6.3606	1.0202	6.1440
<i>T&I</i>	2.3191	4.7682	3.4655	6.1964	3.3500	5.9251
<i>None</i>			12.568	2.1060	13.581	0.8762
<i>GCF</i>						I(0)
<i>Intercept</i>	5.6919	10.001	5.7290	23.750	15.786	10.235
<i>T&I</i>	6.1143	10.373	6.1367	30.799	6.0632	10.160
<i>None</i>			2.1319	19.951	2.4428	10.347

(NOTE: Calculation based on software 7.0 E. views

In the above table I have used Augmented Dickey-Fuller (ADF) , Dickey Fuller-GLC (ERS) 1979 and Philips Perron 1988 test . These tests examine the non-stationary and stationary of data. According to the results all variables are stationary at first difference. (0) shows that variable is stationary at level while (1) shows that variables are significant at first difference. The variables such as GDP gross domestic product, INV investment ,and CON consumption variables are significant at first difference .While INF inflation and GCF gross domestic product are significant at level.

Conclusion and Policy Implications:

This study generally studies how economic stability can be achieved by adopting the Banking system which is based on Islamic law. The main idea of Ribaa-Free banking system is to promote such policies which is based on Islamic laws and Sharia. The Holy Quran cleared that excess earning which is fix is unlawful the earning which is based on profit and loss is lawful. Interest rate is strictly forbidden is Islam. Islam only promotes investment there is no concept of saving. In Islam consumption must be in the principle of Islam like ZAKAT. The only way to achieve economic stability is to increase investment level. While on the other hand interest rate can cause economic disability if rate of interest will increase the more of the people increase savings due to this the level of investment will decline. Consumption only for the sake of buying goods and services can cause inflation because when we increase our consumption level to buying more of goods and services to increase our living standard then prices will increase due to this it will cause inflation and it will also be reason of economic disability.

The moderate spending or spending in the way of ALLAH or for the wellbeing of human can be the factor of economic stability. Instead of issuing interest bearing loans the Islamic banks come into the market and have to introduced the interest free loans to the businessmen on the basis of Mudarbah and Shirakah

basis and profit will be given to the businessmen on basis on contract. This profit will be not fix it can be increase or decrease on the basis of loss and profit. In Mudarbah if capitalist conduct business with the bank's capital, the profit shall be divided in half or by to the percentage or fixed ratio in the agreement of Mudarbah. In Islamic banking economic stability is only can achieved by the investment. Investment and consumption are positively related to the GDP in Islamic economy.

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